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The Hermeneutic Circle of European Insolvency Law

Prof. mr. Bob Wessels

1 Introduction

In their recent book the Spanish professors Virgós and Garcimartín refer to the EC Insolvency Regulation as constituting the general rule, where the Directives with regard to reorganization and winding-up of financial institutions form special rules, but ‘(...) they all form the ‘hermeneutic circle’ within which interpretations should be made. The idea that all these rules must be seen as parts of a consistent (although unfinished) statutory scheme is important’.¹

In this article I will shortly describe the Insolvency Regulation and the Directives mentioned. I will then highlight some differences between both, mainly using illustrations with regard to Directive 2001/24 (banks). I will then discuss the treatment of certain (international) financial contracts, such as netting contracts and repurchase agreements. At the conclusion the quoted characterization as ‘hermeneutic circle’ will be briefly discussed.

2 European Insolvency Law as a scheme

The first decade of the millennium has started with a tremendous growth of European insolvency law. In 2000 birth was given to the aforementioned Regulation (EC) nr. 1346/2000 of 29 May 2000 on insolvency proceedings which entered into force 31 May 2002. Then, for several financial institutions falling outside the Regulation’s scope, 2001 is a good year. Directive 2001/17 of 19 March 2001 on the reorganization and winding-up of insurance undertaking and Directive 2001/24 of 4 April 2001 on the reorganization and winding-up of credit institutions have seen light. Where a Regulation is a European Community law measure binding fully the EU Member States (except for Denmark), a Directive has to go through a legislative implementation process in each individual EC Member State. The implementation date for Directive 2001/24 is 20 April 2003 and for Directive 2001/17 it is 5 May 2004. Some countries are still drafting, though.²

1 Virgós/Garcimartín, *The EC Regulation on Insolvency Proceedings: Law and Practice*, Kluwer Law International, 2004, 9ff.

2 For commentaries on both Directives and for Member State implementation reviews, see Moss/Wessels (eds.), *EU Banking and Insurance Insolvency. An Annotated Guide and Comments on the Implementation of EC Directives 17/2001 and 24/2001 in EU Member States*, Oxford University Press 2006. A large majority of countries have enacted the Directives, with in the rear Belgium (December 2004), Spain and the Netherlands (2005).

The Insolvency Regulation in a way reflects the fact that as a result of widely differing substantive laws ‘(...) it is not practical to introduce insolvency proceedings with universal scope in the entire Community’ (recital 13). The differences mainly lie in the widely differing laws on security interests to be found in the Community and the very different preferential rights enjoyed by some creditors in the insolvency proceedings. The goals of the Regulation, with 47 Articles, are to enable cross-border insolvency proceedings to operate efficiently and effectively, to provide for co-ordination of the measures to be taken with regard to the debtor’s assets and to avoid forum shopping. The Insolvency Regulation, therefore, provides rules for the international jurisdiction of courts in a Member State for the opening of insolvency proceedings, the (automatic) recognition of these proceedings in other Member States and the powers of the ‘liquidator’ in the other Member States. The Regulation also deals with important choice of law (or: private international law) provisions. These contain special rules on applicable law in the case of particularly significant rights and legal relationships (e.g. rights in rem, retention of title, certain contracts relating to immoveable property and contracts of employment). On the other hand, national proceedings (secondary proceedings) covering only assets situated in the State of opening are also allowed alongside main insolvency proceedings with universal scope. The Regulation applies entirely and directly to the ten Member States, which joined the EU as of 1 May 2004.³

It should be noticed that the Insolvency Regulation itself aims to fill a gap that deliberately was left, nearly forty years ago, in the 1968 Brussels Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters. Article 1(1) of this Convention excluded from its scope insolvency proceedings relating to the winding-up of insolvent companies or other legal persons, judicial arrangements, compositions and analogous proceedings. The EU Insolvency Regulation has closed this gap, while the Brussels Convention has been transformed into a Regulation as of 1 March 2002.⁴ Article 1(2) Brussels Regulation 2002 contains the same exclusion. Article 1(2) EU Insolvency Regulation, in its turn, excludes from its scope insolvency proceedings concerning insurance undertakings, credit institutions, investment undertakings, holding funds or securities for third parties, and collective investment undertakings. The Winding-Up Directives for both groups of financial institutions, the insurance undertakings⁵ and the credit institutions,⁶ are

3 Some smaller changes, based on Article 20 of the Act of Accession (O.J. L 236 of 23 September 2003) have led to a consolidated version of the Insolvency Regulation, see http://europa.eu.int/eur-lex/en/consleg/reg/en_register_1920.html. In April 2005, the Annexes A, B and C to the Insolvency Regulation have been amended, see O.J. L of 20 April 2005, pp. 1-8.

4 Council Regulation No. 44/2001 of 22 December 2000, O.J. 2001 L 12/1.

5 O.J. L 110 of 20 April 2001.

6 O.J. L 125 of 5 May 2001. See Deguée, *The Winding Up Directive Finally Establishes Uniform Private Law for Banking Insolvency Proceedings*, in: *European Business Law Review* (EBLR) 2004, 99.

generally seen as to fill the gap left by the Insolvency Regulation (InsReg).⁷ Article 25 InsReg aligns the recognition and enforceability of insolvency related judgments (concerning the course and the closure of insolvency proceedings and court approved compositions) with the Brussels Regulation 2002. Systematically judgments, which are not covered by the Winding-Up Directives, fall within the scope of the Brussels Regulation 2002.⁸

3 A special position for financial institutions

The aforementioned Directives 2001/17 and 2001/24 are the logic result from the fact that the EU Insolvency Regulation expressly excludes from its scope insolvency proceedings concerning banks and insurance companies. According to recital 9 to the Insolvency Regulation the Regulation should apply to insolvency proceedings, whether the debtor is a natural person or a legal person, a trader or an individual.⁹ Insolvency proceedings concerning the aforementioned institutions and undertakings ‘(...) should be excluded from the scope of this Regulation. Such undertakings should not be covered by this Regulation since they are subject to special arrangements and, to some extent, the national supervisory authorities have extremely wide-ranging powers of intervention.’ From the Virgós/Schmit Report (1996), para. 55, it can be taken that the exclusion of credit institutions and insurance undertakings was agreed to by all Member States only after a statement by the Council and the Commission regarding the need to step up work on insolvency proceedings involving institutions and undertakings referred to in Article 1(2) InsReg.¹⁰ The inter-

7 See in this way Paulus, *Banken und Insolvenz – eine Internationale Betrachtung*, Zeitschrift für Bankrecht und Bankwirtschaftrecht (ZBB) 15. December 2002, 457ff, and Pannen, *Krise und Insolvenz bei Kreditinstituten*, 2. Auflage, Carl Heymanns Verlag, 2005, 213.

8 There is still a gap with regard to insolvency proceedings concerning investment undertakings which provide services involving the holding of funds or securities for third parties, or to collective investment undertakings, see Braun/Heinrich, Finanzdienstleister in der ‘grenzüberschreitenden’ Insolvenz – Lücken im System?, in: Neue Zeitschrift für das Recht der Insolvenz und Sanierung (NZI), November 2005, 578ff.

9 The insolvency proceedings to which the Insolvency Regulation applies are listed in the Annexes A and B to the Regulation.

10 The Report Virgós/Schmit (1996) was drawn up as an extensive explanation of the draft-Convention 1995. The Report itself however never has been agreed by the Ministers of Justice of the Member States, as the draft-Convention due to political reasons, never came into being. Nevertheless, because the content of the draft-Convention 1995 and the Insolvency Regulation is nearly the same, the Report has an important interpretative status. This position is quite uniformly taken in literature and by courts. See for Netherlands Supreme Court 9 January 2004, JOR 2004/87, with my comments; NIPR 2004, 41 (*Fortis v. Vennink*); High Court of Justice Chancery Division Leeds 20 May 2004 (*Ci4Net.Com Inc.*), ZIP 2004, 1769; Irish Supreme Court 27 July 2004 [2004] IESC 47 (*Re the Matter of Eurofoods IFSC Ltd*); District Court Dordrecht 11 Augustus 2004 LJN: AQ6547; NIPR 2004/372 (*Müller Gerüstbau GmbH*) and District Court ‘s-Hertogenbosch 31 October 2005,

pretation of the excluded entities and undertakings in Article 1(2) InsReg are not defined by the Regulation itself, but by definitions in other instruments of Community law.

The reasons for this special position of credit institutions lay in the typically financial nature of a bank as a debtor (highly liquid liabilities) and its specific role in a country's economy, see Hüpkes.¹¹ Generally, these are the main reasons to treat banks differently. In the banking community it is furthermore generally recognized that one bank's failure may lead to the failure of many banks, thus causing a chain reaction and widespread failures and the realization of systemic risk. The Underpinnings Contact Group, in its 2002-report on 'Insolvency Arrangements and Contract Enforceability',¹² defines systemic risk as '(...) the risk that the failure of a participant to meet its contractual obligations may in turn cause other participants to default, with the chain reaction leading to broader financial difficulties'. The Group adds: 'Adequate insolvency regimes can contribute to the avoidance of such chain reactions, and thereby systemic risk, by allowing for orderly liquidation or appropriate reorganisation measures and by ensuring that collateral security rights can be enforced and the performance of contracts honoured.'¹³ For these reasons credit institutions should be treated differently with regard to insolvency issues in comparison with 'common' businesses.

4 Applicable sector principles

The work regarding the Directive 2001/24 flows from the First Banking Directive of 1978¹⁴ on the harmonization of the rules of authorization, during which the need for appropriate rules dealing with insolvency already was felt. The EC Commission's objective was to transpose the principle of 'home country control', laid down in the First Banking Directive, to the regulatory framework

LJN: AU5330 (*Collins & Aikman Automotive Trim B.V.*) stating 'the Virgós/Schmit Report, so significant for the Regulations' interpretation.'

- 11 Hüpkes, *The Legal Aspects of Bank Insolvency. A Comparative Analysis of Western Europe, the United States and Canada*, Studies in Comparative Corporate and Financial Law, Volume 10, Kluwer Law International 2000, 7.
- 12 Source: Contact Group on the Legal and Institutional Underpinnings of the International Financial System, Bank for International Settlements, September 2002 (available via <<www.bis.org>> or <<www.ecb.org>>). See Appendix A on 'Cross-border Aspects of Insolvency', p. A26.
- 13 According to *The Economist* January 24th 2004, Italian banks' lending exposure to Parmalat is an estimated € 2.3 billion, about half the lending exposure of all banks in Italy. Nevertheless, there is 'little systemic risk for Italy's banks as a whole', while the loans are spread among many international institutions, including some 15 Italian banks.
- 14 Directive 77/780/EC, which evolved in the Banking Directive 2000 (O.J. L 12 of 26 May 2000, 1, as amended by Directive 2000/28/EC (O.J. L 275 of 27 October 2000, p. 37). See in general: Dale, *Regulatory Consequences of the BCCI Collapse: US, UK, EC, Basle Committee – Current Issues in International Bank Supervision*, in: Norton, Cheng and Fletcher (eds.), *International Banking Regulation and Supervision: Change and Transformation in the 1990s* (1994), 377ff.

for the reorganization and winding-up of credit institutions. Aforementioned financial institutions operate according to the principle of one single license, issued by one Member State, but applicable in all Member States, allowing the institution to carry out its activities in the Community by means of establishment or free provision of services without any further authorization by the host Member State and under the sole prudential supervision of the home Member State supervisory authorities (therefore: 'home country control'). The single license idea relates to the credit institution in one Member State and its branches in other Member States (so called 'single entity'). For this reason the Directives provide for only one main insolvency proceedings, to avoid unnecessary interference because of a secondary insolvency proceeding in another member State.

Furthermore, it should be kept in mind that both Directives broaden the regulatory framework with regard to (prudential) supervision on insurance undertakings and credit institutions. Directive 2001/17 states in recital 3, that the insurance directives, which are providing a single authorization with a Community scope to the insurance undertakings, do not contain coordination rules in the event of winding-up proceedings. It follows: 'Insurance undertakings as well as other financial institutions are expressly excluded from the scope of Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings. It is in the interest of the proper functioning of the internal market and of the protection of creditors that coordinated rules are established at Community level for winding-up proceedings in respect of insurance undertakings.' These rules will be in line with the existing system of the European Community legislative framework on the coordination of laws, regulations and administrative provisions with regard to the taking up and pursuit of the business of these institutions.

The Italian author Galanti submits that the rules concerning private international law, which are included in Directive 2001/24, are placed in a more important and overall framework of exchange of information and cooperation among authorities: 'The circumstance that banks and insurance undertakings are subject to prudential supervision accounts for the allocation of the crisis directives in the EC law derived law in these sectors, thus giving to the rules on private international law a secondary role.'¹⁵ A step further is the opinion of the Belgian author Torremans¹⁶ who states: 'The final aim is therefore not so much to exclude these entities from the scope of the [Insolvency] Regulation, as to put in place a tailor-made special regime for them'. Within the banking sector this view is held too. The Underpinnings Contact Group, in its 2002-report on 'Insolvency Arrangements and Contract Enforceability' underlines the backup

15 Galanti, *The New EC Law on Banking Crisis*, in: *International Insolvency Review* 2002, 49 et seq.

16 Torremans, *Cross Border Insolvencies in EU*, English and Belgian Law, European Monographs nr. 39, Kluwer Law International, 2002, 145.

function of the rules with regard to insolvency of banks to the rules with regard to prudential supervision: ‘The principles of home country control, minimum harmonization and mutual recognition – forming the core of the market integration principles for financial markets – have also been transposed in the field of insolvency procedures and constitute the basis of the Winding-up Directive for insurance undertakings and the Winding-up Directive for credit institutions. In particular, the home country and mutual recognition principles – being introduced by the First and Second Banking Co-ordination Directives, respectively – are extended to the insolvency of credit institutions’.

It can be taken from the above that Directive 2001/24 therefore forms an integral part of the EU’s legislative framework on the coordination of laws, regulations and administrative provisions with regard to the taking up and pursuit of the business of credit institutions as evolved into the 2000 Banking Directive. The Directive is to be seen as to complement the Banking Directives (in addition to taking up business and pursuit of business, now: the winding up or reorganization of the activities) and to fill the legal vacuum. In the text of Directive 2001/24, its complementary function to the 2000 Banking Directive is easy to recognize in adopted definitions (e.g. home Member State; host Member State; branch; competent authorities) and in provisions relating to information with regard to branches of third-countries or the procedure with regard to the withdrawal of authority.

5 Different basis in the EC Treaty

The preamble to Directive 2001/24 refers to the Directive’s legal foundation within the EC Treaty and especially Art. 47(2) EC Treaty and the directives for the coordination of the national laws with regard to the taking up and pursuit of activities as self-employed persons. Its foundation, therefore, is the principle of free establishment or of free provision of services without any further authorization by the host Member State. In general this legal basis is supported by a well-established broad interpretation of this norm, which was already employed as legal basis for the Banking Directives since the 70s, which preceded the 2000 Banking Directive.¹⁷ During the preparatory work it has been recognized that the main topic of the Directive would be its rules on private international law, which would – like with the EU Insolvency Regulation – bring the subject matter within the area of judicial cooperation in civil matters in order to establish progressively an area of freedom, security and justice (Art. 61(c) EC Treaty). This would, amongst other, mean that the European Court of Justice only would be able to provide guidance for interpretation when in a Member State the court of the highest instance would approach the ECJ. It was

17 Galanti, *The New EC Law on Banking Crisis*, in: *International Insolvency Review* 2002, 49.

nevertheless considered that Art. 47(2) EC Treaty could be a suitable legal basis as far as such norms on insolvency law and civil law could be regarded as just accessories and not at the main topic of the Directives. In cases, covered by the Directives, therefore courts in the first instance are authorized to refer questions to the ECJ.¹⁸

6 Main universal proceeding; no secondary proceedings

The applicable sector principles with regard to banks and insurance companies are the main point of view for a different model than the model adopted for the Insolvency Regulation. The Regulation is based on a system of what is called ‘mitigated universality’. Jurisdiction of courts of a Member State according to the Insolvency Regulation is based on the general principle that ‘the courts of the Member State within the territory of which the centre of the debtor’s main interests is situated shall have jurisdiction to open insolvency proceedings’, see Article 3(1). For a company or legal person, the presumption is that the centre of the debtors’ main interests (COMI) is the place of its registered office, but this presumption may be rebutted (Article 3(1) last line). The insolvency proceeding opened is called a main proceeding. Its most important consequence is that the law applicable to insolvency proceedings under the Regulation is that ‘of the Member State within the territory of which such proceedings are opened’, see Article 4(1), thus: *lex concursus*, and that this consequence shall be recognized automatically in all other Member States (Article 16). In addition, the court of another Member State than the State of opening main proceedings shall only have jurisdiction, if ‘the debtor possesses an establishment within the territory of that other Member State’ (Article 3(2)).¹⁹ The effects of the latter proceedings – referred to as secondary proceedings – are however restricted to the assets of the debtor situated in the territory of the other Member State (Article 3(2) last line) and this proceeding may only be a winding-up proceeding. In the framework of main proceedings and secondary proceedings one notes the combination of universality and territoriality, as referred to above.

The ‘centre of main interests’ (COMI) should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties, as Recital 13 provides. In some 80

18 Art. 43 InsReg (Applicability in time as per 31 May 2002) is a logical provision for a Regulation, as a Regulation is binding and directly applicable in Member States. The Directives both have to be implemented in the laws of the Member States. Although the ultimate implementation dates are given (Insurance Undertakings: 20 April 2003; Credit institutions: 5 May 2004), as indicated earlier, in practice not all Member States have succeeded to enact legislation before these dates.

19 Article 2(h) provides that for the purposes of the EU Insolvency Regulation an ‘establishment’ shall mean ‘any place of operations where the debtor carries out a non-transitory economic activity with human means and goods’.

percent of all court cases from the mid 02s²⁰ until now the determination of COMI is the principle point of legal conflict, with highly debated cases like Daisytek (involving sixteen subsidiaries in UK, Germany and France)²¹ and Parmalat (involving Italy, Ireland, the Netherlands and Luxembourg). The outcome of the question ‘where is the centre of main interest?’ in these decisions is based on many facts and circumstances, amongst (very many) others the fact that:

- (i) The day to day administration is conducted in the forum State (Ireland),
- (ii) The directors possessed the forum’s nationality (Italy),²²
- (iii) The (Delaware incorporated) company had presented itself to its most substantial creditor as having its principle executive offices in the forum State (England),²³
- (iv) The debtor (natural person) has maintained, with regard to the substantial interests in a large number of companies established in the forum State, to administer these commercial interest in the forum State (the Netherlands),²⁴
- (v) The director (of an Irish incorporated company, being a wholly owned subsidiary of a UK company) was based in the UK and was solely responsible for the companies business,²⁵
- (vi) Some remaining contractual works (conducted by a company incorporated in Finland) were still in progress in the forum State (Sweden),²⁶
- (vii) The group’s parent company (of an Austrian company with its seat in Innsbruck) is located in the forum State (Germany),²⁷
- (viii) The company (registered in the UK with a postal address in Spain) is a partner in a Swedish limited partnership (‘kommanditbolag’) (Sweden),²⁸ and even
- (ix) The codes to the computer programmes of the debtor company (registered in the UK, postal address in the UK, premises in Sweden) are stored in the forum State (Sweden).²⁹

The European Court of Justice’s decision in Parmalat will probably provide some guidelines to determine COMI with more predictability. It is expected in the spring of 2006.

20 Sources or extracts of some 100 court cases can be found at <<www.eir-database.com>>.

21 These European subsidiaries were left out of a filing of a Chapter 11 U.S. Bankruptcy Code case in the USA (Dallas, Texas) for the overall holding of Daisytek International, Inc.

22 Court of Parma 19 February 2004 in *Re Eurofood IFSC Limited*.

23 Court of Leeds (Ch. D) 20 May 2004 *Re Ci4net.com Inc* and *Re DBP Holdings Limited*.

24 Netherlands Supreme Court 9 January 2004, JOR 2004/87, with my commentary.

25 High Court London (Ch. D) 2 July 2004 in *Re Aim Underwriting Agencies (Ireland) Ltd*.

26 Svea Court of Appeal 30 May 2003 (No. Ö 4105-03).

27 Court of Munich 4 May 2004 in *Re Hettlage KgaA*.

28 Court of Appeal Skåne and Blekinge 3 February 2005 (Ö 21-05).

29 Court of Stockholm 21 January 2005 (K 17664-04).

In the Directives the jurisdiction of courts is not based on COMI and secondary proceedings can not be opened. The idea is that in the single entity approach³⁰ a bank is wound up as one legal entity and that the supervision of the home Member State should not be interrupted. For this reason Article 3(1) Directive 2001/24 captures the question of the exclusive international regulatory authority ('jurisdiction') and the principle of unity. Exclusive jurisdiction is provided to the home Member State's administrative or judicial authorities to decide on the implementation of one or more reorganization measures. Decisive is (not COMI, but) the institution's registered seat. The single entity approach follows from the addressees of the measures 'in' a credit institution 'including branches established in other Member States'. Article 9(1) with regard to winding-up proceedings contains too the provision of international jurisdiction and the single entity approach, see recital 10:

'Only the competent authorities of the home Member State should be empowered to take decisions on winding-up proceedings concerning insurance undertakings (principle of unity). These proceedings should produce their effects throughout the Community and should be recognised by all Member States. All the assets and liabilities of the insurance undertaking should, as a general rule, be taken into consideration in the winding-up proceedings (principle of universality).'

The assets of the bank in its home State jurisdiction are therefore encompassed in the liquidation, which assets include the assets of branches in a host State jurisdiction.³¹ All worldwide creditors can prove their claims in the unified proceeding, to which the *lex concursus* of the opening State applies. As secondary proceedings under the applicable unity principle are not allowed, Articles 27-38 InsReg (Secondary proceedings) are not mirrored in the Winding-Up Directives, which makes sense. For this reason the duty to cooperate and communicate information between insolvency liquidators (Article 31 InsReg) has no mirror rule in the Directives, as these do not provide a system of main and secondary proceedings. Finally, the public policy defence of Article 26 InsReg, which is aimed at the refusal to recognize insolvency proceedings opened in another Member State or a judgment handed down in this context, does not work in the single entity approach. This approach presumes automatic recognition and does not allow a host Member State to call in its public policy

30 Recital 4 Directive 2001/24 states that where, while in operation, a credit institution and its branches form a single entity, which is subject to the supervision of the competent authorities of the State where authorization valid throughout the Community was granted, it would be '(...) particularly undesirable to relinquish such unity' between an institution and its branches where it is necessary to adopt reorganization measures or open winding-up proceedings.

31 See Article 1 point 7 of the 2000 Banking Directive: host Member State is the Member State in which a credit institution has a branch or in which it provide services.

against a reorganization measure of a winding-up decision which has its source in the home Member State.

7 Effects outside the Community

The Insolvency Regulation deals primarily with intra-Community effects of cross-border insolvency matters. Virgós and Garcimartín use the ‘Dan Brownisch’ expression: ‘The Community Connection’.³²

The territorial scope of the Directives 2001/17 and 2004/24 is wider and include all 25 Member States, therefore including Denmark.³³ In addition, the single entity-approach, with one European license, includes all of the EEA (European Economic Area), which would be the EU Member States plus Norway, Iceland and Liechtenstein.

Now, to the non-EU banks. The provisions of Directive 2001/24 concerning the branches of a credit institution having a head office outside the Community shall apply, but only where that institution has branches in at least two Member States of the Community, see Article 1(2) providing a *de minimis*-rule when it comes to the reach of this Directive beyond the EC Community. Directive 2001/24 applies to the branches of a non EC bank when such bank ‘has branches in at least two Member States of the Community’. The way it applies has to be taken from recital 22: ‘Where a credit institution which has its head office outside the Community possesses branches in more than one Member State, each branch should receive individual treatment in regard to the application of this Directive (...)’.³⁴

8 Specific types of measures

Article 1(1) InsReg defines the scope of the applicability of the Insolvency Regulation. It shall apply to ‘collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator.’

³² Virgós/Garcimartín, o.c., 22.

³³ Based on figures presented in the European Central Bank report ‘Structural Analysis of the EU Banking Sector, Year 2001’ (November 2002) one may deduce that in the beginning of 2004 in 15 EU Member States some 7500 credit institutions operate. The number of branches of credit institutions from EEA countries will be over 500.

³⁴ It is discussed whether it is the intention in a situation of a non-EC bank with two or more branches to provide for a single insolvency proceeding in relation to all the branches within a Member State. The text of Directive 2001/24 is unclear and therefore it is uncertain which court should open unitary insolvency proceedings and whether assets of both branches should be pooled together in one single proceeding, see my article Non-EU Insurance Companies and Banks and the EU Directives 2001/17 and 2001/24 on Reorganisation and Winding-Up of Insurance Undertakings and Credit Institutions, in: Wessels, Current Topics of International Insolvency Law, Kluwer, Deventer, 2004, 309.

Several key definitions with regard to the Directives relate to ‘reorganisation measures’ which fall outside the scope of the definition of an ‘insolvency proceeding’. Reorganisation measures shall mean measures ‘(...) which are intended to preserve or restore the financial situation of a credit institution and which could affect third parties’ pre-existing rights, including measures involving the possibility of a suspension of payments, suspension of enforcement measures or reduction of claims’ (art. 2, 7th dash Directive 2001/24). In the definition of ‘reorganisation measures’ the principle elements are (i) the aim of the measure, as a measure, which is intended to preserve or restore the financial situation of a credit institution, and (ii) the effect of the measure, as a measure could affect third parties’ pre-existing rights. Measures of this type include measures involving the possibility of a suspension of payments, suspension of enforcement measures or reduction of claims. The second set of activities to be initiated under the Directives are: winding-up proceedings. The words ‘winding-up proceedings’ shall mean ‘collective proceedings opened and monitored by the administrative or judicial authorities of a Member State with the aim of realising assets under the supervision of those authorities, including where the proceedings are terminated by a composition or other, similar measure’ (article 2, 8th dash Directive 2001/24).³⁵ It seems there may be some detailed differences between the latter one and ‘insolvency proceedings’, which include ‘winding-up proceedings’ (as meant in Article 2(c) InsReg). For the purposes of this article it is sufficient to note the different types of proceedings. It can be noted here that descriptions of ‘measures’ and ‘proceedings’ in the Directives are not supported by Annexes, which lists mentions in each Member State’s authentic language, the type of measures or proceedings concerned, as Annexes A and B to the Insolvency Regulation do.

9 Conflict of Law Rules: *Lex Domus*

Article 4(1) InsReg to insolvency proceedings, which concern natural persons or (non-financial) legal persons, lays down the rules on applicable law to the main insolvency proceedings. This law is the so called *lex concursus*, the law of the Member State of which the court has opened these proceedings. This law governs all the conditions for the opening, conduct and closure of the insolvency proceedings, the admissibility of claims and the rules on distribution and preferences, etc, in all 24 Member States. Art. 10(1) Directive 2001/24 contains a similar rule of the applicable law to the winding-up proceeding. A credit

35 The definitions of ‘winding-up proceedings’ in both Directives differ. The definition in Art. 2(d) Directive 2001/17 adds to the wordings in Art. 2, 9th dash Directive 2001/24, ending with ‘(...) by a composition or other, similar measure’, the wording ‘(...) by a composition or other analogous measure, whether or not they are founded on insolvency or are voluntary or compulsory’.

institution is wound up in accordance with ‘(...) the laws, regulations and procedures’ applicable in its home Member State insofar as the Directive 2001/24 does not provide otherwise. The first part lays down the same rule as applies ex Article 4(1) InsReg. There is one difference, though. Article 10(1) Directive 2001/24 does not determine that the ‘law’ of the home Member State is universally applicable, it provides that ‘the laws’ (plural) and ‘(...) regulations and procedures’ of the home Member State are applicable. To symbolize (at least in its wording) this broader regime I suggest to refer to ‘laws, regulations and practices’ as the ‘lex domus’, in contrast to the *lex concursus* as meant in Article 4(1) InsReg. These procedural and substantive effects of the *lex concursus* are in a broad sense quite typical for insolvency law and are also necessary for the insolvency proceedings to fulfil its aims, but it is submitted that it has a much wider effect for banks in that *lex domus* includes ‘regulations’ and ‘procedures’ not being ‘law’ in a strict sense, e.g. regulations following from capital adequacy standards, from information standards to use in reporting lines to the supervisory authorities, preventive procedures with regard to safety in use of technology or supervisory procedures based on a cross-border Memorandum of Understanding concerning coordination and cooperation between supervisory authorities in different (Member) States or certain internal regulated measures concerning to prevent financing ‘terrorism’.

10 Conflict of Law Rules: exclusions

The central starting point of Directive 2001/24 is that the ‘laws, regulations and procedures’ applicable in the home country (*lex domus*) determine re-organization measures or winding-up proceedings. During the final negotiations of the draft-Directive a group of exceptions to the applicability of the *lex domus* has been inserted, e.g. employment contracts remain subject to the law of the Member State whose legislation was applicable to the employment contract and a contract conferring the right to make use of or acquire immovable property is governed by the law of the Member State in whose territory the immovable property is situated (*lex rei sitae*), and rights with respect to immovable property (including ships and aircrafts), subject to registration, are governed by the law of the Member State under the authority of which the register is kept, see Article 20(a)-20(c) Directive 2001/24. Both in these situations as with regard to rights in rem, reservation of title and the right to set-off (Article 21-23 Directive 2001/24) the Directive adopted in principle the rules as arranged in the Insolvency Regulation. Hüpkens notes that there is concern that such a conflict of law rule is not specific enough and would need further elaboration.³⁶ These

³⁶ Hüpkens, o.c., 168, explains that the status of rights in rem and reservation of title rights are typically determined not only by the law of the location of the assets, but also by the law governing the

concerns equally relate to the interpretation of e.g. Article 5-7 InsReg and therefore literature and court cases analyses on applying these articles are of interest for the proper understanding of the conflict of law rules in the Directives.³⁷

In the banking sector three other Directives are paramount with regard to insolvency questions, the EU Directive on Deposit-guarantee schemes (1994/19), the Settlement Finality Directive (1998/26) and the June 2002 Directive 2002/47 on financial collateral arrangements (the EU Collateral Directive). The two latter ones create specific legal regimes which in general are forthcoming to the international banking practice. This approach seems to have been followed in the Directive 2001/24 in that protection is offered to positions based on specific financial contracts, e.g. with regard to netting and repurchase agreements, see the next paragraph. The Insurance Directive 2001/17 contains certain provisions with regard to harmonizing the system of protection of rights of policy holders, see Article 10-12 with regard to the protection of insurance claims, including these of policyholders.³⁸

11 The Treatment of Financial Contracts

Article 25 of Directive 2001/24 provides: 'Netting agreements shall be governed solely by the law of the contract which governs such agreements', and Article 26 determines: 'Without prejudice to Article 24, repurchase agreements shall be governed solely by the law of the contract which governs such agreements.' Galanti³⁹ reports that the introduction of these exceptions to the *lex domus*, provided for in Article 25 and 26 have been vigorously debated in the last phase of the preparatory works for the Directive. The exceptions apply, instead of the *lex domus*, the *lex contractus*.⁴⁰ Two opposite stances emerged during these discussions. The first was against the introduction of these exceptions. The view was taken to limit as much as possible the number of exceptions, which were perceived as not consistent with the universality principle and the original nature of the proposal. In this view it was underlined that some of these exceptions

underlying contract. In the insolvency context, the law governing the insolvency proceedings ultimately determines the extent to which those rights can effectively be realized in a winding-up, sometimes resulting in a preferred treatment of holders of these rights.

37 See my article *The Secured Creditor in Cross-border Finance Transactions Under the EU Insolvency Regulation*, in: *Journal of International Banking Law and Regulation*, Volume 18, Issue 3, 2003, 135.

38 See critically on the rationale and the lack of detail my article *A Glance Through the Legal Principles and Key Issues of Multinational Bank Insolvency*, in: *Wessels, Current Topics of International Insolvency Law*, Kluwer, Deventer, 2004, 259.

39 Galanti, *The New EC Law on Banking Crisis*, in: *International Insolvency Review* 2002, p. 61.

40 The same goes for Article 27 (transactions carried out in regulated markets). It will not be discussed here.

were first introduced to safeguard transactions carried out in payment, netting or settlement systems which, eventually, found suitable protection under the Settlement Finality Directive. The second stance, which was pro introduction, was essentially based on the argument that such norms have a scope broader than the Settlement Finality Directive ones, encompassing – beyond the systems and the markets and therefore reaching not only the settlement but also – the dealing and the bilateral ‘netting’ agreements. An additional argument was found in the positive effect of the norms in terms of continuity of the applicable law even in case of insolvency.

Recital 23 and 24 to Directive 2001/24 underline the special position of the exempted agreements, by stating that in some cases ‘... reference to the law of another Member State represents an unavoidable qualification of the principle that the law of the home Member State is to apply, ... especially necessary to protect ... the integrity of regulated markets functioning in accordance with the law of a Member State on which financial instruments are traded.’ The exclusions, however, in the text of Article 25 and 26 adopt a wider view. Agreements meant in Article 25 and 26 ‘shall be governed solely by the law of the contract’ which governs such agreements. Galanti notes that a serious assessment of the windfall in terms of competition among legal systems was lacking: ‘In (...) repurchase agreements (...) the parties (...) can usually choose the law applicable to such legal relationships without any territorial constraint. In such a framework, the exception to the principle of application of the *lex concursus* allows the financial intermediaries to choose the most favorable law in terms of effects of the insolvency on these contracts. The intermediaries are there advantaged vis-à-vis the other creditors and counterparts of the disrupted bank and there is a risk of competition among legal systems in reducing the negative effects of the insolvency on such contracts. The stance pro exceptions already prevailed at Council level but, following the opinion of the EU Parliament, the link with a Member State law was eventually erased in favor of the *lex contractus* in general which could lead, in the future, to a disintermediation of the European markets.’⁴¹

Given the text and its history the references to the *lex contractus* in Articles 25 and 26 are to be understood as to refer to the law which the parties choose to apply to their contract (netting or repurchase contract) and this law could also be the law of a non-EEA State. This approach has several disadvantages, including the uneven treatment of creditors and depositors (as far as they are not protected by a scheme). Cercone submits that the application of the *lex contractus* in the aforementioned way is ‘excessive’. This author wishes to read in the *lex concursus* a reference ‘to the statutory laws applicable to the relationship; statutory laws could then permit the parties to exercise self-governing powers,

41 Galanti, *The New EC Law on Banking Crisis*, in: *International Insolvency Review* 2002, p. 61.

but always within certain limits and conditions.⁴² Although it is not entirely clear what is meant here, a narrow interpretation may be desirable, even though it may not follow from the history and the text of the provisions itself.

The Insolvency Regulation, although not applicable to credit institutions, provides for a special rule with regard to the agreements mentioned and transactions, dealt with in Articles 25 to 27 of the Directive. Article 9(1) Insolvency Regulation (Payment systems and financial markets) provides the following:

‘Without prejudice to Article 5, the effects of insolvency proceedings on the rights and obligations of the parties to a payment or settlement system or to a financial market shall be governed solely by the law of the Member State applicable to that system or market.’

Recital 27 to the Insolvency Regulation states: ‘There is also a need for special protection in the case of payment systems and financial markets. This applies for example to the position-closing agreements and netting agreements to be found in such systems as well as to the sale of securities and to the guarantees provided for such transactions as governed in particular by the [Settlement Finality Directive]. For such transactions, the only law which is material should thus be that applicable to the system or market concerned. This provision is intended to prevent the possibility of mechanisms for the payment and settlement of transactions provided for in the payment and set-off systems or on the regulated financial markets of the Member States being altered in the case of insolvency of a business partner’, adding that the Settlement Finality Directive contains special provisions which should take precedence over the general rules in the Insolvency Regulation. Articles 25 to 27 of the Directive seem to follow this path.

It is very unfortunate that the word ‘netting’ has not been defined. Recital 25 of Directive 2001/24 seems to limit the netting agreements as meant in Article 25 of the Directive by providing that transactions carried out in the framework of a payment and settlement system are covered by the Settlement Finality Directive, although it merely repeats what already is found in the (recital to the) Insolvency Regulation. Also recital 26 of Directive 2001/24 seems to narrow the width of Article 25, by saying that the adoption of Directive 2001/24 does not call into question the provisions of the Settlement Finality Directive to which insolvency proceedings must not have any effect on the enforceability of orders validly entered into a system, or on collateral provided for a system. Probably Article 25

42 Cerncone, European Community Directive on Reorganization and Winding-up of Credit Institutions; Exceptions to the Application of the *lex concursus* (Title IV, Articles 20-27 and 30-32), in: European Business Law Review (EBLR) 2004, 688.

covers bilateral close out netting,⁴³ but parties may wish to stress ‘netting’ into all sorts of intertwined transactions with set-off elements. It is submitted that because a party in a netting arrangement luckily escapes the *lex domus* of the reorganisation measures or the winding-up proceedings, to the detriment of other creditors, a very narrow interpretation of what ‘netting’ represents is to be applied.⁴⁴ With regard to repurchase agreements the Financial Settlement Directive 98/26/EC already protected repurchase agreements, whilst a repo transaction concluded by or for the benefit of a credit institution in its capacity as participant in a payment or securities settlement system or for the benefit of central banks shall not be affected by insolvency proceedings. Like Article 25 (netting agreements), Article 26 (repos) seems unfinished, as a definition of ‘repurchase agreement’ is missing as is a provision stating that Article 26 – the same goes for Article 25 – shall not preclude any action for voidness, voidability or unenforceability which may be taken to set aside netting agreement under the law of the contract which governs such agreements.⁴⁵ Like netting the sanctity of a repo, following from its importance for the stability for the financial markets, may well be the reason for this special treatment.

12 Conclusion

Now back to the contention of the Spanish professors Virgós and Garcimartín in that the Insolvency Regulation constitutes the general rule, where the Directives 2001/17 and 2001/24 form special rules, but ‘(...) they all form the ‘hermeneutic circle’ within which interpretations should be made. The idea that all these rules must be seen as parts of a consistent (although unfinished) statutory scheme is important’.

It is submitted that within the field of the regulation of insolvency or ‘near-insolvency’ situations the Winding-Up Directives 2001/17 and 2001/24 form an

43 See: Wessels, Close-out Netting in the Netherlands, *Journal of International Banking Law*, Vol. 12 Issue 5, May 1997, 187, reprinted in: Wessels, *Business and Bankruptcy Law in the Netherlands; Selected Essays*, Kluwer Law International, The Hague-London-Boston, 1999. As netting is not defined it should, at least, be understood as referring to ‘the essentially bilateral process of close-out, conversion of obligations into monetary claims, and mutual set-off’, according to European Financial Markets Lawyers Group, *Protection for Bilateral Insolvency Set-off and Netting Agreements under EC Law*, October 2004, p. 42 (available through www.efmlg.org). The Group has studied Article 6 Insolvency Regulation and Article 25 Directive 2001/24 to conclude that the legal protection for close-out netting provisions is highly uncertain, for which reason it recommends to redefine the term ‘close-out netting provision’ in Article 2(1)(n) of the Collateral Directive 2002/47.

44 I leave aside characterisation of netting as ‘set-off’ to which again different rules apply, see Article 6 Insolvency Regulation and Article 24 Directive 2001/24.

45 See for Article 26 in a broader context: Deguée, *The Winding Up Directive Finally Establishes Uniform Private Law for Banking Insolvency Proceedings*, in: *European Business Law Review* (EBLR) 2004, 114.

important part of the legal and regulatory framework concerning the European single market for the insurance and the banking sector. I have demonstrated though that both Directives encompass three principles, namely (i) 'single entity', the credit institution in the home Member State and the branch in another Member State form one legal entity, (ii) 'unity', resulting in only one competent authority, exclusively empowering the home country authority, or one winding-up proceeding with no secondary proceedings elsewhere,⁴⁶ and (iii) 'universality', the effects of reorganization measures or winding-up proceedings and its applicable law (*lex domus* being the '*lex concursus*') shall in principle apply throughout the whole Community. Both Directives add an important component to the rather fresh EU rules regarding jurisdiction, recognition and conflict of law rules concerning insolvency proceedings. The Directives require an early exchange of information between supervising authorities and enable for coordination of reorganization measures or winding-up proceedings for insurance undertakings and banks with branches in other Member States. Both Directives are EU legal measures and therefore obviously the natural limitation applies: the Directives mainly focus on Europe, including the other EEA countries, although they both contain several provisions, which are of importance for branches of non-EU insurance undertakings and credit institutions.

The last five years indeed in Europe a framework for insolvency has been established. When European insolvency legislation (including supervisory rules and insolvency law) would be seen as one painting, it strikes that it is still unfinished (lacking rules for (collective) investment undertakings), with some conflicting lines (doubtful justification for different treatment of financial institutions), some mismatching colours (principle of coordinated universality, which includes secondary proceedings, in the Insolvency Regulation versus the principle of unity and universality in both Directives) and some parts which differ in its perspective of the daylight (certain elements of Directive 2001/24 need to be interpreted in the context of the 2000 Banking Directive).⁴⁷ Taste and appreciation comes into play when answering the question whether the painting is realistic. Quite some corporations and banking organizations conduct their business in corporate groups, operating cross-border and – for financial institutions – cross-sector ('bankassurance').⁴⁸ Certainly, there is a 'hermeneutic

46 Including specificity, see e.g. recital 16 Directive 2001/24, which provides a foundation for the rule of international jurisdiction that Art. 9(1) Directive 2001/24 introduces with regard to the opening of winding-up proceedings: 'Equal treatment of creditors requires that the credit institution is wound up according to the principles of unity and universality, which require the administrative or judicial authorities of the home Member State to have sole jurisdiction and their decisions to be recognized and to be capable of producing in all the other Member States, without any formality ...'

47 Leaving aside suggestions for general improvements, see Wessels, *The European Insolvency Regulation: Three Years Later*, in: *European Company Law* 2005/02.

48 In the opinion of the European Monetary Institute (EMI), published O.J. C 332/13 of 30 October 1998, the EMI already encouraged further proposals for Directives relating to non-credit institution

circle' in the context of general rule – special rules (Regulation – Directives). In this respect the Directives should be interpreted in alignment with the EU Insolvency Regulation (e.g. type of proceedings; conflict of law rules). In addition one will have to swing around that circle in that with regard to financial institutions specific community principles (free establishment), particular financial sector principles ('single entity'; 'unity') and norms ('lex domus') come into play, and these will apply in a wider pitch, including the EEA countries and affecting branches of non EU banks.

financial entities and on reorganization and winding up of a branch of one undertaking on other entities within the same corporate group.